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MONTERREY 00000438 001.2 OF 002

¶1. (SBU) Summary. Reaction to the passage of the modified 2009 Fiscal Law in Nuevo Leon ranges from stoic to pessimistic. Local business leaders and economists cite decreasing competitiveness, growing uncertainty, uncontrolled spending, and a failure to broaden the tax base among their strongest criticisms. While Nuevo Leon's large maquiladora sector shares much of this criticism, it expects to suffer fewer negative consequences due to changes in the tax code. End Summary.

¶2. (SBU) The Chamber of Transformational Industry of Nuevo Leon (CAINTRA) has been an early and credible critic of the fiscal package. The President of CAINTRA, Andres Garza Herrera, argued in interviews with local media before passage of the bill that the best way to meet revenue shortfalls was to eliminate exceptions to the corporate income Tax (ISR), expand the Value Added Tax (IVA) to include food and medicine, and reduce spending, concentrating particularly in public retirement benefits. After passage of the bill, Guillermo Dillon Montana, Director General of CAINTRA, expressed disappointment with the fiscal package, noting that the legislature had made insufficient efforts to reduce spending, which had increased over 90% in the last 8 years and that no effort had been made to expand the taxpayer base.

¶3. (SBU) In a private conversation with Econoff, Dillon elaborated on his earlier public comments, noting that while other governments were creating stimulus to deal with the economic crisis, Mexico's fiscal policy was precisely the opposite. He declared that not only would this package remove capital from the most productive sector of Mexico's economy, but that many of the taxes seemed almost designed to reduce Mexico's competitiveness and punish those most in need of opportunity. He cited the tax increase on telecommunications, as an example, noting that Mexican internet and telephony were already less efficient and more expensive than those in competing nations.

¶4. (SBU) John Castany, President of the Nuevo Leon Maquiladora Association (AMNL), was more sanguine about the changes. He explained that while maquiladoras, businesses dedicated to assembly for export, represent a great portion of the industry in Nuevo Leon, they operate under a special tax regime. They use a transfer pricing scheme to determine their tax burden when selling product to their US holding companies, and so are minimally impacted by the new fiscal package. He noted that maquiladoras were profitable years ago when the ISR was 34%, and

so those that pay the ISR now (vice the IETU, a flat rate business tax) can handle an increase from 28% to 30%. Because maquiladoras don't sell their product in Mexico, they are largely unaffected by the IVA.

¶5. (SBU) The one area where Castany felt maquiladoras might suffer was in the proposal to roll back "consolidation," a tax avoidance strategy whereby a holding company writes the losses of one subsidiary off against the profits of another. Changes made to current law are retroactive, meaning that companies not only will have to change their tax strategies going forward, but will have to recalculate their obligations going back as far as six years. Castany felt that this was not only burdensome, but contributed to an environment of greater uncertainty for potential investors.

¶6. (SBU) In Castany's opinion, this greater uncertainty is significant for both Mexico and the US. He notes that when a US corporation relocates operations to Mexico, its supply chains are largely left intact. However, when corporations move operations to Asia or elsewhere overseas, they take their supply chains with them, resulting in an even greater loss of jobs within the NAFTA community. Thus, he sees the issue of sound fiscal policy and tax policy in Mexico as contributing not only to the economic health of the country, but to the competitive power of North American trade relative to Asia and the European Union.

¶7. (SBU) Robert Chandler of the Monterrey chapter of the American Chamber of Commerce (AMCHAM) echoed Castany's conclusion that maquiladoras wouldn't be as adversely affected

by changes to the tax code as other sectors of Mexican industry. However, he noted that the nation as a whole was growing less competitive on an international scale; he felt that the current package failed to address this completely, and would, in fact, worsen the situation in several respects. He suggested that the effective collection rate for the IVA - generally regarded as the most efficient tax collected by the GOM - was only about 48%, and that other taxes were even less effectively enforced. Noting that entrenched patterns of tax evasion and poor rates of collection summed with uncontrolled government spending resulted in an inability to balance the budget, Chandler stated that the GOM ran a serious risk of a decline in its sovereign credit rating.

¶8. (SBU) Chandler further emphasized that such a loss of confidence in Mexico's fiscal policy, combined with factors such as overpriced energy and telecommunications which contribute to the country's lack of competitiveness, would drive away even more foreign direct investment. He noted multinationals such as Caterpillar and Nestle had already chosen to invest in their operations in Brazil instead of Mexico, and he expected that others would follow suit.

¶9. (SBU) Comment. All the individuals with whom Econoff spoke recognize Mexico's need to manage its debt in order to maintain its sovereign credit rating, attract foreign investment, and foment economic growth. Yet all see the tax increases levied upon the formal sector in an attempt to do this - in particular the portion retroactively altering the rules of consolidation - as even more discouraging to foreign direct investment and economic growth than increasing the national debt. Guillermo Dillon Montana of CAINTRA, in commenting on this dilemma, noted that controlling spending is the only real solution, but that

this has proven politically impossible. Accordingly, his organization feels that political reform is necessary before Mexico can even attempt real economic reforms. CAINTRA is drafting a national reform proposal which will call for such dramatic changes as a reduction in the number of elected representatives and allowing for their reelection in hopes of increasing continuity and technical knowledge among the governing class. CAINTRA hopes to disseminate this proposal through Mexico's largest business associations, including the Owners Confederation of the Republic of Mexico (COPARMEX), the Confederation of Chambers of Industries of Mexico (CONCAMIN), the Confederation of National Chambers of Commerce, and the Business Coordinating Council (CCE). Dillon acknowledges the magnitude of the challenge involved in affecting such reform, but feels that it is the only way forward.
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